RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

January 17, 1979 **LETTER 748**

Jan. 5, DJIA 823.89; PTI 872; A-D Ratio −20.45
Jan. 12, DJIA 836.28; PTI 883; A-D Ratio −19.95

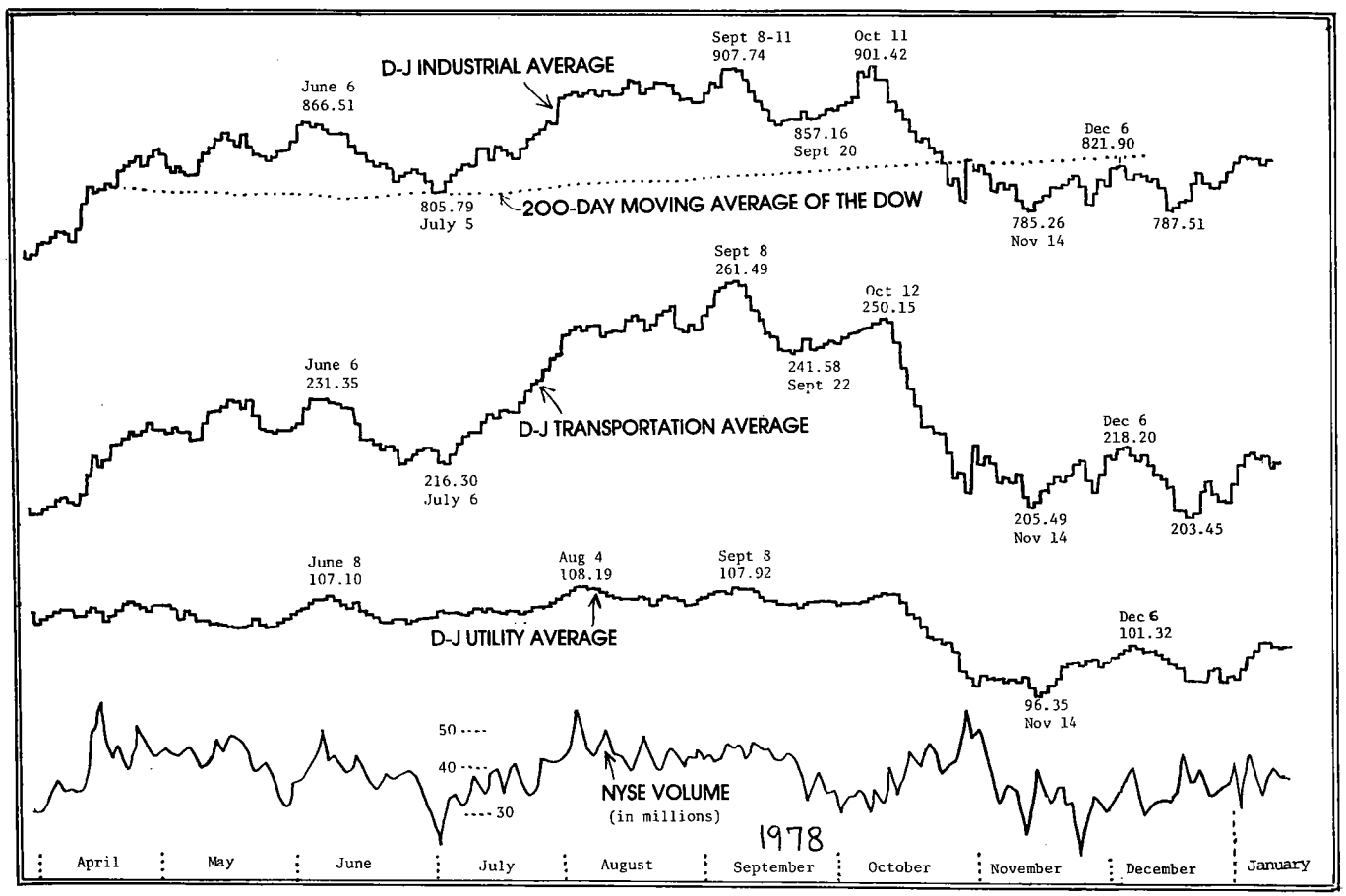
THE MARKET: Seldom has a market been confronted with so many perplexities, cross-currents and dilemmas. On the one hand we have a Dow selling at 8.2 times earnings, yielding 5.8% and priced below actual book value. On an historical basis, the Dow would appear to be cheap on its own merits. But on the other hand, we have a bond market which provides yields far above stock yields, we have rampant inflation, we have an inept Administration which is either too weak or too ignorant to attack the problems of the day, and we are facing a world that is crumbling, with the crumbs falling rather consistently into the lap of the Communists (Russian Communists, that is).

Is it any wonder then, that the stock market has presented us with a mass of inconsistencies and puzzles? On January 5 the negative volume index (see Letter 746, page 5) rendered a major bullish signal by bettering its previous peak and reversing its first declining trendline. But during the same week the 13-week moving average of the Dow (now at 820) sank below the 50-week MA of the Dow (now at 822), thereby giving us a bearish signal.

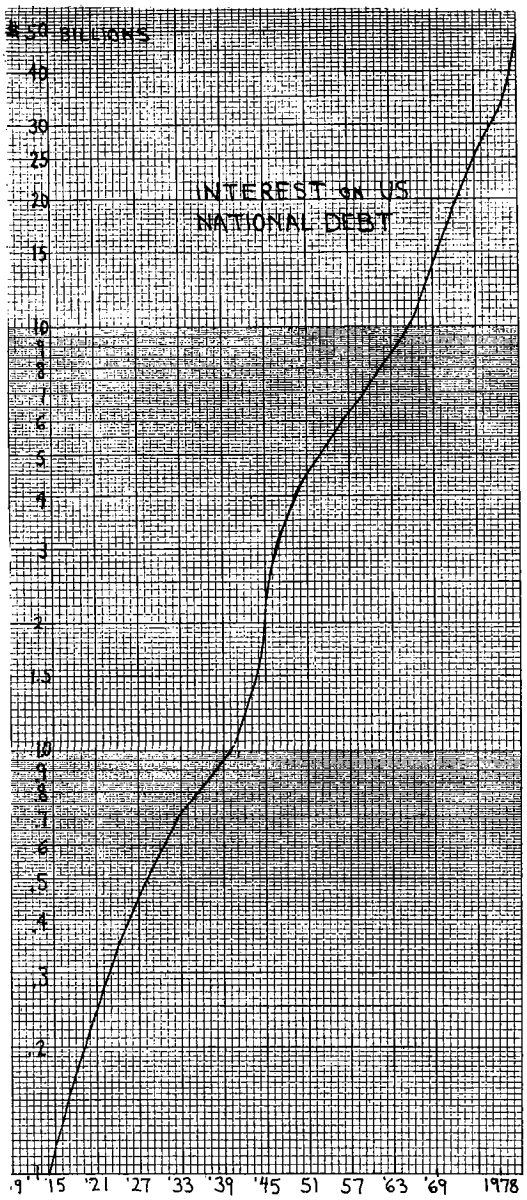
From the standpoint of the Dow Theory, the Averages are also telling us that the verdict is not yet in. On December 20 (see chart below) the Transports broke below their previous low, the November low of 205.49. This penetration was not confirmed by the Industrials, which held about 2 points above their November 14 low of 785.26. On the strength of this non-confirmation, the market rallied into January. On January 4 the Industrials bettered their December 6 peak of 821.90. But here, the Transports hesitated, refusing to better their own December 6 peak of 218.10. In the face of this non-confirmation, the market fell back. A new rally began on January 10, but by the 12th (with Industrials closing at 836.28) Transports had still not confirmed. Unfortunately, this Letter was completed on Sunday (Jan. 14) and I am off tonight for NYC. Therefore, I cannot know whether the new week will see a successful Transports bettering of the 218.20 level or not. But by the time you get this Letter, you should know whether it's "all clear" above, or whether the Transports are saying "danger."

Another split decision is provided by the money components of the Averages. Note that on January 4 the Utility Average bettered its December 6 peak of 101.32. This would ordinarily be considered a plus for the stock market. Yet the D-J 20 Bond Average has steadfastly refused to confirm the Utilities. The Bonds have been steadily sinking, and as late as January 12 the 20-Bonds slid to 84.11, their lowest level in three years.

Turning to the daily chart of the Dow, the Primary Trend Index and the A-D Ratio, we see the Dow heading up from its November 14 low, and the move has been confirmed by the A-D ratio (the A-D has bettered its December high). But the PTI is still 12 points below its own December peak (a non-confirmation which could be rectified by two days of good upside action).



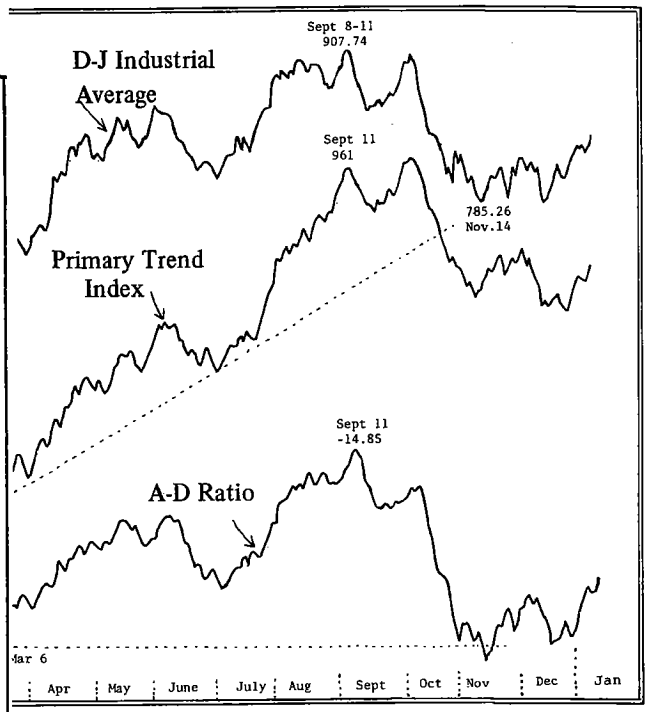
OUTER SPACE: I believe charts are the best way to illustrate financial events. Last week I sat down and charted the annual INTEREST on the national debt—not the debt, mind you, but just the interest. I took my chart back to 1915. I also used a ratio chart so we could see the actual rate of change. The results are both edifying and frightening.



In 1915 the interest on the national debt was $23 million. By 1918 (World War I was over) the interest had jumped to $190 million. By 1929 the interest rose to $678 million. The year 1943 saw the interest in the billion dollar zone—at $1.8 billion. Following WW II the interest on the debt rose to $3.6 billion—that was 1945. In 1965 with inflation beginning to rear its head the interest pushed over $10 billion to $11.3 billion. By 1970 the interest had doubled again—to $19.3 billion. By 1975 the interest (due to huge deficit spending and higher interest rates) tripled the 1965 figure and rose to $32.6 billion. In 1977 the interest climbed to $42 billion. For 1978 I would guess that the interest on the debt would be near $50 billion!

It's easy to see what lies ahead. The chart tells us the story. Either we enter a growth-inflation explosion which may help to finance the careening interest on the debt (and the interest should reach around $80 billion by 1981) or the rate of change in the rising interest costs must turn down. The only way that it will turn down is via a crushing depression and an across-the-board reduction in Federal expenses. If anyone else sees another possible outcome for this chart, please let me know about it.

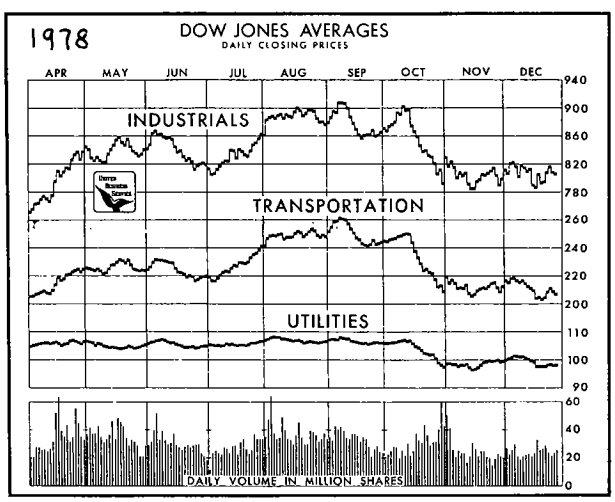
Heavy resistance should be encountered in the Dow 850-875 area, and the market is already moving into semi-overbought territory. Without the "major bottom" which I have been talking about for months, I suggest leaving this rally to the speculators. From here on, every passing week brings us nearer to what should be an historic cyclical bottom.



THE PICTURE: Question: What would happen if all the economic news ahead was known by the market? **Answer:** The market would stand still—it would do absolutely nothing. Why? Because the market's function is to DISCOUNT. And news known is news already discounted. Therefore, if the market knew what lay ahead, it would have nothing to discount, consequently there would be no movement.

Today, it seems to me that almost every thesis is being put forth, talked about, analyzed. Some talk inflationary boom, others talk deflationary depression, still others talk mild growth while a large contingent predicts inflationary stagflation. In this type of environment, my experience is that we get a trading range market characterized by frustrations and unprofitable limited swings. Actually, this was the kind of market we experienced during 1978, and in proof I include this weekly chart (below) of the D-J Averages covering the past year (courtesy of United Business Services).

There are a few interesting concepts that I want to discuss at this time. One is a long-term study that I follow which shows that since 1949 the market has never gone more than 52 months without the appearance of a major oversold market bottom. There have been periods (such as



1966 through 1970) when more than one such major over-sold bottom has appeared, but never have 52 months elapsed without at least one historic bottom showing up.

The last major bottom on this study materialized during September-October, 1974. February 1979, will mark the 52nd month since October, 1974. Therefore, we can say that every month from here on increases the odds that history will repeat and that the market will be heading towards an historic bottom.

Because of this study, I feel that the longer the market fluctuates in its current price range (characterized by the Dow 950 on the upside and 785 on the downside), the poorer the odds for making real money on any stock market swing. The reason, to put it another way, is that from here on the market will be fighting historic cycles that have proved correct for a quarter of a century.

A second consideration which I personally think is important is my study of Fibonacci numbers in relation to the stock market. I have not reviewed my Fibonacci work for almost a year, and this seems like a good time to go into it again.

Veteran readers know that the Fibonacci series is an integral part of the Elliott wave studies. The Fibonacci series is obtained by adding each two preceding numbers to obtain the next. For instance, 1 plus 1 equals 2; 2 plus 1 equals 3; 3 plus 2 equals 5; 5 plus 3 equals 8, and so forth to 13, 21, 34, 55, 89, etc. This series occurs so frequently in nature that it is utterly beyond coincidence. For instance, age of maturity is 21, 8 notes to the musical scale, 13 the beginning of the teen-age, 5 appendages to the body (head, two arms, two legs), five fingers to the hand, five toes, on and on.

I don't have time to go into the hundreds of ramifications of the Fibonacci series, but suffice it to say that the series has helped me immensely in my stock market work.

The following observations based on Fibonacci time sequences are listed. Those who wish to place them in the "coincidental" category are free to do so.

3 years from the 1976 top to the year 1979.
5 years from the 1974 bottom to 1979.
13 years from the 1966 top to 1979.

21 months from October, 1977 (where most secondary stocks hit bottom) to *July, 1979.*

34 months from the September 21, 1976 Dow top to *July, 1979..*
55 months from the December, 1974 Dow bottom to *July, 1979.*

Thus, the six time sequences listed above point to the importance of the year 1979 and more specifically to JULY, 1979.

Combining the two studies here is what we have.
(1) We know that February, 1979, will be the 52nd month since the last historic bottom which occurred in October, 1974. No market since 1949 has gone more than 52 months without producing a major bottom. But it looks as if this one will.

(2) May, 1979 is interesting because May would be the 55th month since the October, 1974 bottom–and 55 is a Fibonacci number (By the way, Richard Russell will also turn 55 years of age on July 22, 1979).

(3) July, 1979 shapes up (from a Fibonacci standpoint) as a crucial month for the stock market. We could see a major bottom for the market in that month.

One final thought for this section. What item or situation could produce a major over-sold situation in the market in 1979? Well, the money situation is well known, Iran has been thoroughly analyzed, inflation is the most talked-about subject in the nation, everyone knows a recession is at least possible in '79. So my guess is that something NEW (and as yet not discounted) is going to show itself this year. And that new phenomenon could well send the market down to an historic bottom.

MUSINGS: This would be a marvelous business if the stock market conformed to definite patterns and say rose for two or three years, then declined for exactly six months, then rose for another few years. Unfortunately, that isn't what happens on Wall Street. Therefore I write 26 Letters a year instead of only one or two.

In other words, those 26 Letters allow me time and room to change my mind. And I tend to change my mind or alter my thinking whenever the market alters its "thinking." Because, as I've written so many times before, I like to dream up scenarios and paint pretty pictures, but basically what I really do is FOLLOW the markets. Furthermore, I try to position my subscribers (and my own investments) WITH the markets. That procedure requires constant thinking and rethinking of the evidence which is presented on Wall Street.

It's clear to me that what Mr. Carter and the Administration are **trying** to do is walk that thin line between inflation and recession. Up to a few months ago, it was obvious that the Administration was content to live with (or ignore) inflation. When the dollar all but collapsed, Mr. Carter was shaken out of his dream world and was forced to deal with the problem. Ironically, the dollar at its recent lows was fantastically oversold. The dollar was therefore ready to respond to almost anything that smacked of a defense. Since its mid-November low, the US greenback has popped up mightily, and Mr. Carter & Co. have taken bows for their hastily dreamed up "defense."

But it's becoming increasingly clear that this Administration is not going to put the economy in a vice, at least not if they can help it. Instead, our leaders are going to try to "keep it all going" with a copious money supply (money is still very available). At the same time they are going to allow money to get expensive (not tight, just expensive).

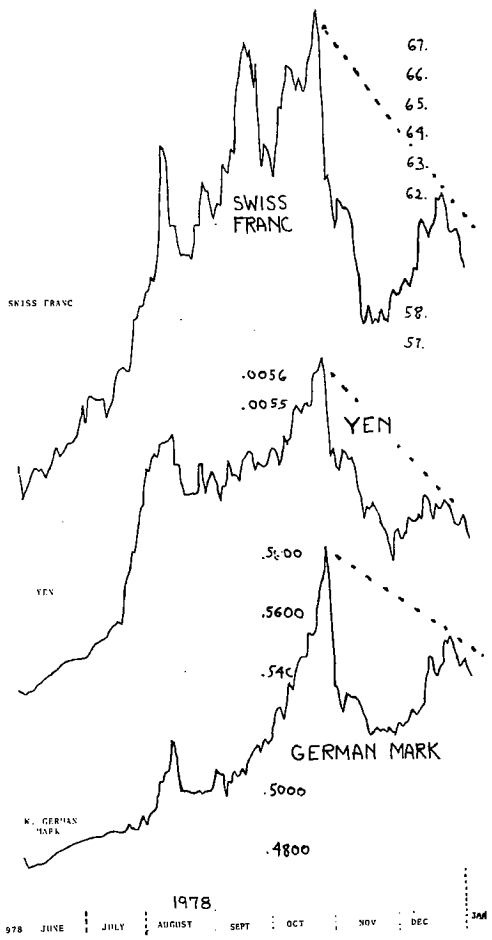
Speaking of interest rates, however, reminds me that I have my own version of what's going on. In my considered opinion, the Carter Administration is still **fighting recession rather than inflation**. I base this on the fact that money instruments still provide NO REAL RETURN on investment. By this I mean that with an inflation rate which is probably over 9%, neither T-bills nor notes nor bonds offer any real return **over** the prevailing rate of US inflation. When we see the squeeze progress to the point where money instruments offer a real return–at that point I'll believe this Administration is fighting inflation. To provide a real return, I would say that T-bills would have to go to yields of 12% or better as would Aa-rated bonds.

So it seems that the Administration and the Fed are going to play the "firm interest rates and all the money you want" game as long as they can–and as long as the markets will allow them to play. And the consumer, even though he is drowning in his own debt, will continue to take on debt and more debt until something unforeseen occurs. But time is running out, and the charts may already be hinting as to the end of the story.

How is it all going to work out? If I had to write the scenario, I would say that business will continue to simmer along, people and businesses will continue to borrow–until the nation goes into a severe credit crunch with accompanying high interest rates, a drastic squeeze on liquidity and all the trimmings. In the face of the high interest rates, the dollar is going to turn very STRONG against the hard currencies (the yen, the Swiss franc, the mark), and gold is going to break with those currencies.

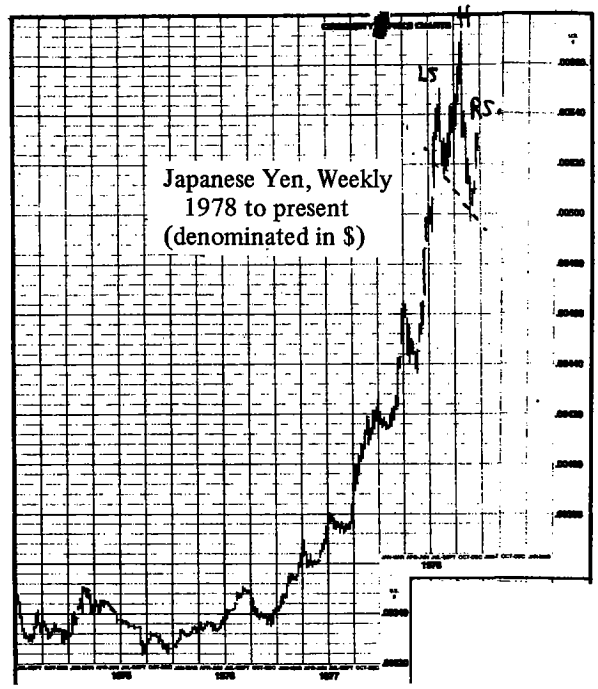
The first reaction to the stronger dollar (and the dollar is fairly strong even now) is a strong stock market and a dip in interest rates. But once the credit crunch is on, everything will go down against the dollar–the stock market, commodities, foreign currencies, gold, the works. The result is going to be violent, chaotic markets, great fear on the part of consumers and businessmen–and the beginning of a recession. I believe that there is a good chance that the recession will be severe, and that it will, in time, turn into depression. But that may be looking too far ahead.

Now there's no question in my mind but that the market sees all these possibilities. And I believe that's the reason the stock market has been behaving in such a "freaky" way, moving up and down in fits and starts, going dead, then rushing up, then declining. A lot of movement but going nowhere. After all, the nation is piled up with debt on the one hand, and it is swimming in dollars on the other hand. Debt is deflationary, while the flood of dollars is inflationary. Thus, the whole mix is dangerous, volatile and constantly in flux.



I show here my daily charts of the three "hard" currencies, the yen, the mark and the franc. Note that they all smashed (along with gold) during October-November. Now they have completed their recoveries, and the recovery rallies have already topped out. Note the head-and-shoulders tops which formed in the mark and the franc, and note the very weak recovery in the yen! Why, what is happening?

What I think is happening is that the world markets (plus gold) are sensing the approaching US money crunch. The money crunch means very high interest rates, and those interest rates are going to produce the "hard dollar" that I have been talking about. Against that hard dollar, I see almost everything going down. If that happens it will be a shocker for all to behold.

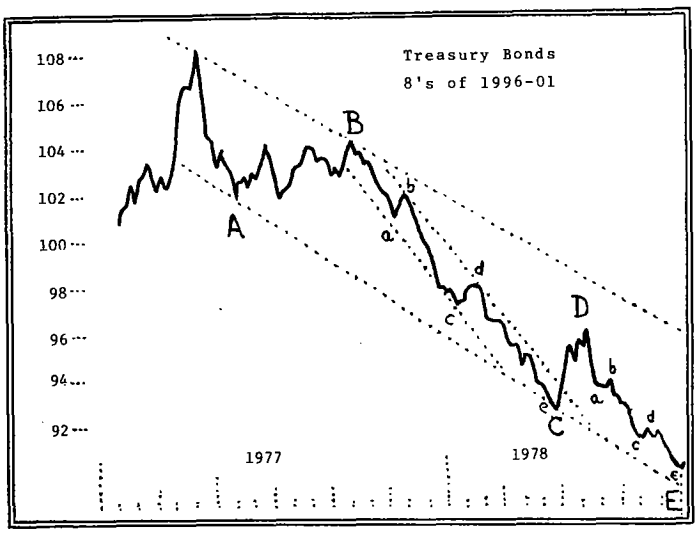


To show you what could happen, I am including this weekly chart of the Japanese yen going back to 1975. Here we see the remarkable spike-rise in the yen, with the head-and-shoulders top now forming. On a pure technical analysis basis, it looks as if the yen could crash against the dollar. And it would not surprise me if that occurs during early-1979–along with severe drops in the other currencies and gold.

What would happen if the dollar (via a money crunch) turned super-strong, and the various markets fell apart? The answer is that it would catch the US (and most of the world) with its "economic pants down." They would not be prepared for an explosion in interest rates and dollar strength, and the damage could be terrific. If all this comes to pass, and my charts increasingly say that it will, then the place to be would be in a position of LIQUIDITY. And the most liquid place, as I see it, would be in US Treasury paper. There you would have the best of both worlds–real liquidity, and high yields. Anyway, that's the way I see this story unfolding here in early 1979.

BONDS: I show here my daily chart of the Treasury 8's of 1996. This bond has now come down from a 1977 peak price of 108 to the current price of just over 90. This represents an incredible drop of 16.6% on this highest-grade of all available debt paper. After all, this bond has behind it the full faith and taxing power of the US Government. If it doesn't pay its 8% coupon, the US Treasury is "broke."

The bond has declined in the classic Elliott five waves down, an A-B-C-D-E pattern as shown. The B leg is clearly sub-divided into 5 smaller legs. The E leg is also sub-divided into 5 smaller legs. At point E the bond has resisted making contact with the lower



trendline of the channel–and this is a **positive** point. I am now thinking that the Treasury bonds have probably entered a buying range. I base this (1) on my technical studies, (2) on contrary opinion, (3) on the fact that in the current area of 9% yields, the Treasuries offer what I consider "great value." At the current yield, the Treasuries (with almost no risk) offer average yields 53% above the Average yield on the D-J Industrial Average!

Consequently, I believe that subscribers should now watch the 8's of 1996 carefully (quotes are in the daily paper). At 91 bid, the 8's will have bettered their first minor declining trendline and also a minor preceding peak. At 91 bid, I recommend taking 1/3 the money that you are holding in T-bills and buying of 8's of 1996. I believe the odds on profits in these bonds now **far outweighs the risk of loss.**

NOTES & QUOTES: Two items burst out of California in the past year, Proposition 13 and Nathan Pritikin and his "longevity diet." Actually Pritikin has been around for quite a few years, but his theories are only now gaining wide publicity and acclaim. Since probably 25% of my subscribers are overweight and at least 50% are over 40 years of age, I thought I'd pass this on. Personally, I think Pritikin is a genius. I've been reading nonsense and bunk about diets for decades, but I believe Pritikin really has many of the answers.

He has shown where clogged arteries can actually become unclogged through exercise and a non-fat, non-salt, non-sugar diet which he calls his "regressive diet." And I'm *convinced* that it works. At any rate, articles about Pritikin appear in this month's *San Diego Magazine, Los Angeles Magazine* and in this month's *Town & Country*. If you have any kind of heart trouble or vascular trouble or if you are overweight, I urge you to get hold of one of these magazines (*Town & Country* is national) and read the articles. Of course I have a selfish motive in all this–I want my subscribers to live to be 100 or over! P.S. I've been on the diet 2 weeks now.

* *

I thought the following, from "Poppa" Eliot Janeway's Janeway Letter, January 3, was so interesting that it deserved inclusion here: "*The quickest false alarm of the year was the instant media forecast of a renewed oil shortage. But the glut is here to stay, though the OPEC price increase isn't. The Shah's downfall this year spells Carter's downfall next year. His failure to prop Iran against Russia coincided disastrously with the timing of his arbitrary decision to pull the props out from under Taiwan; and it gives both Begin and Sadat every incentive to straight-arm him. Carter got nothing from China and lost everything in Iran. So he's now a set-up for his challengers in both parties to express the wonder and the worry forming in everyone's minds over whether Carter knows what he's doing, and if it's safe to wait and find out. A market break sometime in 1979 against a background of punitive interest rates is all it will take to isolate Carter from any support in the new Congress and position him as a sitting duck.*"

* *

A few years ago I published two chart albums. The first showed the daily Dow and A-D ratio going back to the early 1930's. I sold 2,000 of these albums, and there are now no more for sale. The second album shows the four D-J Averages (Industrials, Transports, Utilities, Bonds) plus volume, all on a daily basis. Each year has its own 11 X 17" page, and the pages go back to 1885. Important highs and lows are shown on the pages and comments are included regarding outstanding historical events. The Dow Albums are hardcover and are 3-ring binders so that each year a new page can be added.

I have a limited number of the D-J Averages albums still left. Price is $49 ($52 if you live in the golden state). The new 1978 pages are now available for *both* the A-D albums and the D-J Albums, price is $2 for each page. I recommend the D-J Averages albums to all market students as one of the finest and most comprehensive stock market studies available (one of the reasons I constructed these albums is that I wanted the albums myself and they just weren't available).

* *

Howard Ruff has come out with a new book entitled, "How to Prosper During the Coming Bad Years." I think I've read and written my share of bearish scenarios, but I must admit that this book frightened me. I don't know whether it's Howard's gifted writing or the simple logic of Howard's predictions, but I couldn't put the book down. I read it in a night, and ended wiping the sweat off the palms of my hands. Howard might have titled the book, "What To Do About the Crash of '78 or '79 or '81." At any rate, the book is a crash course (pun intended) in all facets and angles of surviving in the coming years, and I recommend this book to everyone. Personally (and I thought I was a hardened veteran), I was surprised at how many things I learned from Ruff 'n Ready Howard. (Hard cover $8.95, published by the (would you believe) New York Times!).

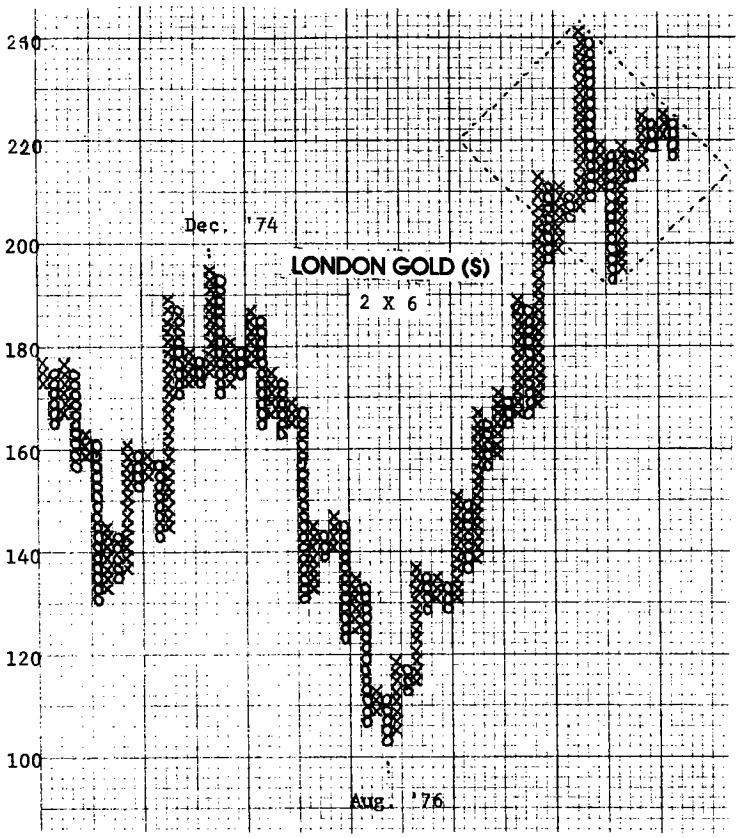
* *

I just re-read Harry Browne's "Complete Guide to Swiss Banks" (McGraw Hill, $9.95). I consider this book a part of everyone's financial education. It's a thorough, easy-to-understand tome on the Swiss banks covering pros and cons, how to do it, why to do it, and whether to do it. I recommend this book to anyone who has the least interest in foreign finance, Swiss banks, and correct procedure for husbanding one's finances.

A number of years ago (I don't remember just when) Bob Prechter of Merrill Lynch's research department got in touch with me and expressed interest in the Elliott Wave Principle as I occasionally expounded it. I had further correspondence with this brilliant young man over the years. About two years ago A. J. Frost (probably the leading expert on Elliott) suggested that he and I write a new and much-needed book on Elliott. I thought about this and decided that the project (in view of my commitment to my own subscribers) was just too much for me.

It was a lucky decision. Frost decided to do the book with Prechter, and the results, I am sure, are far beyond anything Frost could have done with me. This is a definitive, excellent book on Elliott, and I recommend it to all who have an interest in the Wave Principle. "Elliott Wave Principle, Key to Stock

Market Profits" is published by New Classics Library, PO Box 262, Chappaqua, NY 10514. Once again I'll repeat that I get not a penny from anything recommended in this Letter–and that has always been my policy.



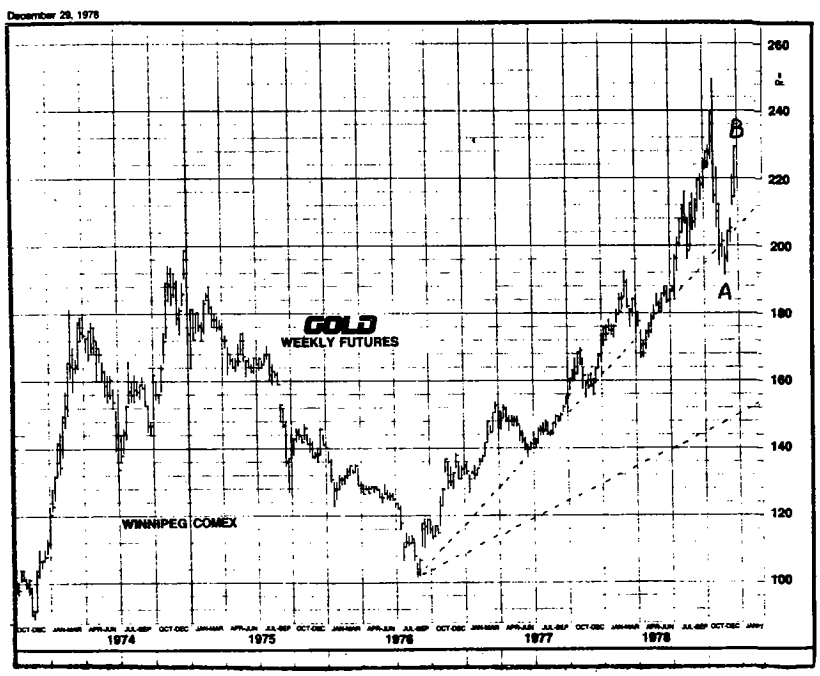
GOLD: Gold is fluctuating within the "diamond top" pattern which I described in the last Letter. The metal came up to the 226 box on the 2 X 6 point & figure chart as shown. It touched the 226 box twice, then turned down. Last week the first definite bearish signal was given for gold when the metal broke below its preceding low (i.e., the 220 box on the chart) and halted at the 218 box. A second sell signal would be given at 214, and a third sell signal at 212. The entire diamond pattern would be ruptured at 202, at which point gold would be in line for a testing of the recent low at the 194 box.

It would now require a rally to 228 on this chart to turn gold bullish again. However, 228 would also serve to break gold out on the upside of the diamond pattern, so the 228 figure would be doubly bullish.

The bottom chart is courtesy of Commodity Price Charts, 219 Parkade, Cedar Falls, Ia. 50613. It is a "continuation chart" which shows gold futures going back to 1974. I have applied Edson Gould's "speedline" concept to the chart. The higher trendline is known as the 2/3 speedline, and this line was broken on the October-November selloff. As a rule, when the 2/3 speedline is broken, the price movement will come down and test the 1/3 speedline. The 1/3 speedline is represented by the lower dotted line. If the price of gold was to come down and contact this line, it would decline to the 160 area–although the longer the elapsed time of descent, the higher the ultimate bottom level (since the lines slant upward).

Gold momentum (the 13-week rate of change) was 125 at the recent 243 high. Last week momentum dropped to 97. This means that gold is now 97% of its price 13 weeks ago. As a rule, once momentum breaks down (as it has done), it takes quite a while for the item to get back on the bullish track again. So as I see it, gold, at best, has a good deal of consolidating, rebuilding and re-accumulating to do. At worst, we're seeing a major top and the end of the second phase of the gold bull market (the latter is what I've been saying all along.

I believe that we've now seen the end of the B-leg (upward corrective leg) of the A-B-C pattern which should be a major corrective pattern for gold. If I'm right, then we should now be in the C-leg or the final down-leg of the correction. Certainly everyone had a chance to lighten up on this B-leg (as I suggested they do). And since the upward B-leg was extended via news (the OPEC price rise and the Iran mess), gold prices obtained on the B-leg were even better than I had expected they would be. So from here on, we should be watching the unwinding of the C-leg to the downside. And 212, then 202 are the critical numbers to watch



Don't get me wrong, I still firmly believe that only gold is real money and all paper is an IOU against gold (if paper is not an IOU against gold, then, as John Exter says, it's an IOU-nothing). But timing is crucial in the markets, and the markets are saying that the dollar, at least for a while, is going to be strong (and the dollar pays interest).

In due time, gold will have its third phase (bull market) boom, and when that boom comes, it's going to be quite something else. But the purpose of this second phase reaction in gold is to wear everyone out, knock them out, scare them out–and in so doing, put gold back in rock-strong hands again. Once that is done–watch out!

LATE NOTES: Mmmm, with bonds perhaps near a bottom, with the money supply since June only up 4% (on an annual basis), with the stock market far below the 1976 and '78 highs, with everyone somewhat bullish about the economy for 1979, it strikes me that we could be within months of the beginning of a recession.

NEXT MAILING: January 31st